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IN THE

Supreme Court of the United States

October Term, 1941.

314 U.S. 68

No. 656.

NORMAN JOHNSON, Suing on Behalf of Himself and All Other Stockholders in THE CURTIS PUBLISHING COMPANY Similarly Situated Who, Being Interested in the Subject Matter of the Complaint, Shall Become Parties Hereto,

Petitioner,

against

WALTER D. FULLER, MARY L. C. BOK, FRED A. HEALY, CARY W. BOK, BENJAMIN ALLEN, PHILIP S. COLLINS, BRUCE GOULD, PHILIP S. ROSE, WESLEY W. STOUT, LEWIS W. TRAYSER, JOHN B. WILLIAMS, and THE CURTIS PUBLISHING COMPANY,

Respondents.

Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit, and Brief in Support Thereof.

ARTHUR GARFIELD HAYS,
120 Broadway, New York City,
Solicitor for Petitioner.

JOHN SCHULMAN,
SEYMOUR M. HEILBRON,
ALAN S. HAYS,
Of Counsel.

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IN THE

Supreme Court of the United States.

October Term, 1941.

NORMAN JOHNSON, SUING ON BEHALF OF HIMSELF AND ALL OTHER STOCKHOLDERS IN THE CURTIS PUBLISHING COMPANY SIMILARLY SITUATED WHO, BEING INTERESTED IN THE SUBJECT MATTER OF THE COMPLAINT, SHALL BECOME PARTIES HERETO,

Petitioner,

—against—

WALTER D. FULLER, MARY L. C. BOK, FRED A. HEALY, CARY W. BOK, BENJAMIN ALLEN, PHILIP S. COLLINS, BRUCE GOULD, PHILIP S. ROSE, WESLEY W. STOUT, LEWIS W. TRAYSER, JOHN B. WILLIAMS, AND THE CURTIS PUBLISHING COMPANY,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Your petitioner, NORMAN JOHNSON, respectfully represents:

SUMMARY STATEMENT OF THE MATTER INVOLVED.

This case challenges the legality, on both constitutional and equitable grounds, of a "Plan of Reorganization and Recapitalization" of the defendant, The Curtis Publishing Company (hereinafter called the "Company"). The plan was devised at the instance of common stockholders in con-

trol of the Company's management for the primary purpose of evading payment of dividend arrearages on the preferred stock and cutting down the preferences of the preferred stock in other important respects as shown below (35).* It purported to be effected under Article VIII, Section 2582-801 of the Business Corporation Law of the Commonwealth of Pennsylvania where the Company was incorporated and domiciled. The statute is set forth in the appendix to the brief annexed hereto.

Petitioner is an owner of the Company's preferred stock (19) and brought a representative action to have the plan of reorganization declared invalid; to enjoin payment of principal and interest on the Company's debenture bonds and of dividends on its prior preferred stock until payment of the accumulations on his shares; or, alternatively if the Court held the plan otherwise valid, to require the Company's directors to pay to the Company the amount which the Company should have received but did not receive upon the issuance of new securities under the plan (3-18).

On April 30, 1940, the Company's capitalization consisted of 722,420 shares of $7 cumulative preferred and 1,733,041 shares of common stock exclusive of shares held by the Company (31). There was no funded debt (41; 20). There were accumulated unpaid dividends of $19.37½ per share on the preferred stock (35). On the above mentioned date, a proposal styled "Plan of Reorganization and Recapitalization" was submitted by the Board of Directors to the stockholders, under which:

(A) Consenting preferred stockholders might exchange each share of preferred (including accrued divi-

* Numbers refer to page numbers of Appellant's Appendix unless otherwise stated.

dends) for one newly created $10 3% debenture, one share of newly created *prior* preferred stock having a dividend rate of $3 cumulative plus $1 if earned, and 2½ shares of newly created common stock.

(B) The Company's stated capital would be reduced by $7,224,200 which sum would be transferred to surplus against which the new debenture bonds would be charged when issued (32).

(C) Non-consenting preferred stockholders might continue to hold their preferred shares, the values behind which, however, would be vitiated (1) by the creation of the senior preferences attached to the new debentures and prior preferred stock above mentioned; (2) by the reduction of $7,224,200 in stated capital; and (3) by the distribution of surplus at the rate of $10 per share exclusively to the consenting preferred stockholders.

(D) Common stockholders holding shares of no par value would receive new common shares of no par value, share for share.

(30-43)

At the time the plan was promulgated, the preferred stockholders held a liquidation preference at the rate of $119.37½ per share, consisting of $100 (41) plus the accrued dividends. As against this preferential right, the Company's net assets behind each share of preferred stock were only $52.80 (20). Immediately after the plan was consummated and by virtue of its operation the equity of the dissenting preferred stock which remained outstanding was wiped out in toto. The equity in *all* of the Company's net assets was diverted to the preferred stockholders who con-

sented to the plan. These consenting stockholders, to the exclusion of the dissenters, not only received the above-mentioned distribution of $10 per share in the form of debentures which reduced the surplus by approximately $6,700,000 but the entire balance of the Company's net assets became applicable to their newly issued prior preferred stock on which the liquidation preference was $65 per share (33).

The preferred stockholders were faced with these alternatives; if they accepted the exchange specified in the plan, they would be required to surrender shares entitled to $100 on liquidation, $120 on redemption and a dividend rate of $7 (26-29). They would receive in place thereof a prior preferred stock entitled to $65 on liquidation, $75 on redemption and a maximum dividend rate of $4 (33); plus the debenture and common stock above described. Those accepting the plan would likewise be required to surrender their claim for accumulated dividends of $19.37½ per share. The plan expressed confidence that regular dividends on the prior preferred stock would be paid uninterruptedly (35). As against this, the plan held out no hope for dividend payments to the dissenting stockholders.* The dissenting stockholders could retain their shares together with the claim for accumulations but they would be subordinated and deprived irrevocably of their equity since, as above stated, the assets were insufficient in amount to cover the preferences of the newly created senior securities.

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* This prognostication proved justified. Shortly after the new stock was delivered to the public, a regular dividend of 75¢ per share on the prior preferred stock was declared payable January 1, 1941 (25) but no dividend was declared on the unexchanged preferred stock even though this was the "regular" date for the payment of dividends thereon.

The right of the dissenters to accumulated dividends, though not "waived", would be rendered virtually meaningless, there having been a diversion of the funds with which to pay them and there being no reasonable prospect currently or in the foreseeable future of earnings sufficient to pay the accumulations as well as the sinking fund and interest requirements on the debentures and the dividend requirements on the prior preferred stock.

The common stockholders on the other hand were faced with no dilemma. Although there was a surplus of $20,000,000, the Company had fixed its stated capital at so low an amount that the capital together with the "surplus" was only sufficient to cover the preferred stock by less than half (41). In consequence, the common stockholders had no equity. Their position was such that according to the Company's treasurer there was no hope of an equity ever being established for them (85, 72) under the Company's capitalization prior to the plan. Their proportionate interest in the total common stock was diminished by half because of the new common stock issued to assenting preferred stockholders under the plan, but the interest which they relinquished was one-half of zero (85). In return for giving up one-half of a non-existent equity their position was improved substantially, first by reason of the waiver of accumulated dividends by the assenting preferred stockholders, and second by reason of the diminution of preferential rights in respect of the preferred stockholders who accepted the plan.

The plan was consummated over the protest of petitioner and other stockholders. The holders of more than 60,000 shares of preferred stock refused to make the exchange of securities.

Without the affirmative vote of the defendant Company's officers, directors and associates,* the plan would not have received the percentage of votes required for approval (37, 38; 21, 22). These persons (37, 38) held some preferred, but were interested chiefly in the common stock (49.3% of the outstanding shares) on which no dividends could be paid because of arrears on the preferred. Out of 12,131 holders of preferred stock, 5,617 of those who held preferred stock and who did not also hold common stock either voted against the plan or did not register their votes at all (22).

The record shows that the chief beneficiaries of the plan were the Company's officers, directors and associates, and the other common stockholders. According to a defendants' witness, a purpose of the plan was to divert earnings from the preferred to the common so that the common-stock-management would not try "to make money in other ways" to the disadvantage of those holding preferred shares (86). The Company itself faced no emergency. Witnesses for the defendants testified that there was no financial stringency facing the Company (91) and that on the contrary the Company's credit was superlatively good (87).

The evidence shows also that during the period 1933-39 while dividends were accumulating on the preferred stock, the Company spent $5,938,137 for purchases of its own common and preferred stock (66-78). According to the Company's treasurer, the money was not used to pay dividends because that would have been "milking the Company" (83). The amount spent for stock purchases, to-

* "Associates" as defined by Rule X-14A-8 of the Securities and Exchange Commission under the Securities Exchange Act of 1934.

gether with the $6,700,000 which was charged against the issuance of debentures as above stated, would have been sufficient to pay practically the entire accumulations on the preferred shares (35).

The District Court rendered judgment dismissing the complaint (Opinion printed at 118).

The plaintiff having duly appealed to the United States Circuit Court of Appeals for the Third Circuit, that Court, on June 27, 1941, affirmed the judgment. The opinion of the Honorable John Biggs, Jr., Circuit Judge, is printed in the record submitted herewith.

STATEMENT OF JURISDICTION

The jurisdiction of this Court is invoked under the provisions of Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925 (United States Code, Title 28, Section 347 (a)).

QUESTIONS PRESENTED.

The following are the questions presented by petitioner:

I.

A. May a corporation organized under the laws of Pennsylvania amend its articles of incorporation so as to

(a) Create debenture bonds and prior preferred stock and, without obtaining any cash or property or any benefit to the corporate entity, issue these newly created securities to assenting preferred stockholders upon the condition that such stockholders waive their claim to accumulated dividends and accept diminished preferences, while

(b) Non-assenting preferred stockholders who retain their shares are subordinated to the new debentures and prior preferred stock, and

(c) The assets of the company which, before the amendment were insufficient to cover the preferential claims of the preferred stockholders are shifted in their entirety, against the will of such stockholders, to support the preferential claims of the debenture holders and prior preferred stockholders, thus wiping out the equity of the non-assenting preferred stockholders, while at the same time

(d) The common stockholders, who have no equity, receive new common stock, share for share?

B. If the Business Corporation Law of Pennsylvania authorizes such an amendment, does not the Law in that respect violate Article I, Section 10 and the Fourteenth Amendment of the Constitution of the United States?

II.

A. Is not the decision in this case refusing to enjoin payments on the new prior preferred stock and debentures inconsistent with the decision of the Supreme Court of the Commonwealth of Pennsylvania in *West Chester & Philadelphia R. R. Co. v. Jackson*, 77 Pa. St. Rep. 321, wherein it was held that a preferred stockholder who refused to exchange his shares for new prior preferred stock in a "voluntary" recapitalization was entitled to receive all of the accumulated dividends on his stock before the corporation could pay any dividends on the new prior preferred stock; and did not the Circuit Court of Appeals err in failing to apply the principle of that case herein?

B. Did not the Circuit Court of Appeals err in refusing to hold that the payment of dividends, interest and sinking fund requirements on the prior preferred stock and

debentures while accumulated dividends remain unpaid on the unexchanged preferred stock constitutes an unlawful invasion of petitioner's vested rights guaranteed by the Constitution of the United States?

III.

A. May a corporation organized under the laws of Pennsylvania amend its charter so as to distribute a substantial portion of its surplus through the issuance of debentures where such distribution is restricted to those preferred stockholders who waive their vested rights to accumulated dividends and is denied to other preferred stockholders of the same class who refuse to waive their vested rights?

B. If the Business Corporation Law of Pennsylvania authorizes a charter amendment having the effect above described, does not the Law in that respect violate Article I, Section 10 and the Fourteenth Amendment of the Constitution of the United States?

IV.

A. Were not the assets of the corporation in this case employed for a purpose not germane to the business of the corporation inasmuch as they were shifted under a plan for the purpose of inducing preferred stockholders to give up rights so that ultimately the common stockholders would benefit, and may a State properly authorize a corporate charter to be amended so as to permit such use to be made of the corporate assets?

B. If the Business Corporation Law of Pennsylvania authorizes such use of corporate assets, does not the Law in that respect violate Article I, Section 10 and the Fourteenth Amendment of the Constitution of the United States?

V.

Is not the decision in this case inconsistent with the decisions of this Court in *Southern Pacific Co. v. Bogert*, 250 U. S. 483, and *Jones v. Missouri-Edison Electric Co.*, 144 Fed. 765, cert. denied, 229 U. S. 615, wherein it was held that dominant stockholders of a corporation occupy a fiduciary relation to minority stockholders and may not use their power to benefit themselves at the expense of the minority; and did not the Circuit Court of Appeals err in failing to apply the principle of such cases?

VI.

A. Prior to the reorganization herein, did not the preferred stockholders enjoy a vested right in the defendant company's net assets to the extent that, except for distribution on dissolution or for the payment of dividends the Company was required to keep such assets intact (subject only to diminution by losses in business operations) to safeguard the preferential rights of the preferred stock; and did not the charter amendment adopted under the plan of reorganization unlawfully destroy such vested right of those preferred stockholders who refused to waive their vested right to accumulated dividends, since it deprived them of all of their entire equity in the assets originally behind their shares without their consent and against their objection?

B. If the Business Corporation Law of Pennsylvania authorizes a charter amendment having the effect above described, does not the Law in that respect violate Article I, Section 10 and the Fourteenth Amendment of the Constitution of the United States?

VII.

A. Did not the Circuit Court of Appeals err in failing to hold that the reorganization of the corporate defendant

was invalid inasmuch as the reorganization gave substantial recognition to the common stockholders who had no equity in the corporate assets?

B. Is not the decision herein inconsistent

(1) with the principle of the decision of the Supreme Court of the Commonwealth of Pennsylvania in *Petry v. Harwood Electric Co.*, 280 Pa. St. Rep. 142, 124 Atl. 302, wherein the Court expressly recognized that in a case of merger, common stockholders would not be entitled to receive any new securities unless there were sufficient assets to pay preferred stockholders in full; and

(2) with the principle of the line of decisions of this Court commencing with *Northern Pacific Co. v. Boyd*, 228 U. S. 482; and did not the Circuit Court of Appeals err in failing to apply the principles of such cases?

REASONS FOR GRANTING THE WRIT.

The writ should be granted because:

(a) This Court has never passed upon the principal question here involved, namely, to what extent a plan of recapitalization may be imposed upon non-consenting stockholders. This question is one of wide importance.

(b) Substantial constitutional questions are involved. *Article I, Section 10* and the *Fourteenth Amendment* of the Constitution of the United States.

(c) On other important aspects of the case, the decision of the Circuit Court appears to be in conflict with decisions of this Court and the Supreme Court of Pennsylvania.

Southern Pacific Co. v. Bogert, 250 U. S. 483;

Northern Pacific Ry. Co. v. Boyd, 228 U. S. 482;
West Chester & Philadelphia R. R. Co. v. Jackson, Admx of Gray, 77 Pa. St. Rep. 321;
Petry v. Harwood Electric Co., 280 Pa. St. Rep. 142, 124 Atl. 302.

"Recapitalization" is rapidly becoming a mode for wiping out dividends which have accrued to preferred stockholders and for diminishing preferences on liquidation and redemption.

During the days of the depression many companies were unable to pay preferred stock dividends out of current earnings. When, however, business improved so as to show larger earnings, the managements of these companies have sought means to get rid of the obligation to preferred stockholders in order to enable dividends to be paid on the common stock in which the management ordinarily is more interested. A simple scheme, which has arisen to such proportions as to become a public scandal, is to issue a new prior preferred stock (and perhaps debentures as in this case) with the intimation that this will pay immediate dividends and that those who hold their old preferred stock will have their claims both to dividends and on liquidation deferred indefinitely. The Curtis Publishing Company at all times had a surplus twice the amount of accumulated preferred dividends. It was in no financial difficulty. The management, however, regarded the payment of accrued dividends as a "milking" of the company and thus proposed a plan to avoid this situation.

This Court has never considered the legality or fairness of these "voluntary" reorganization plans, prepared and forced through by a common stock acknowledgment.

Insofar as they impair the quasi-creditor right of the preferred shareholders to be paid due and accrued divi-

dends, they present a Federal question arising under the Constitution. In view of the widespread use of this type of plan and millions of dollars in preferred dividends that annually are being taken away from innocent and largely helpless small investors, the subject would seem of such importance to entitle it to review and examination by this Court.

The right of preferred shareholders to be paid dividends that have accrued under the cumulative provision of the stock has been referred to as a vested property right or interest in many of the decisions. If it be such a property right, it is entitled to some reasonable degree of protection and this it is not afforded under these plans.

This Court, in other decisions, has laid down certain basic principles governing the obligations of majority stock managements to the powerless minority. The treatment accorded the small stockholders in these plans of recapitalization runs counter to the holdings in these decisions and to every concept of fair play.

Again, the law on the subject is in a most unsatisfactory state, with conflicting decisions on every side and the rights of investors left to the unguided judgment of each particular judge.

In *Davison v. Parke, Austin & Lipscomb, Inc.*, 285 N. Y. 500 (May 29, 1941), the Court of Appeals of the State of New York held that dissenting preferred stockholders were entitled to receive accrued dividends before any dividends could be paid on certain new preferred stock issued under the recapitalization plan involved therein. The Court said at page 506:

> "The issue thus presented is today one of great importance. It is common knowledge that during the

past few years many corporations have been unable to pay dividends either upon common stock or preferred stock and that large amounts of unpaid cumulative dividends, constituting as they do a first charge upon future profits, have a tendency to discourage new investment. Balanced against the desire to encourage investment, however, is the sanctity of the rights of contract. The individual preferred stock investor has bargained for certainty in his return, and may not be deprived of his bargain without express statutory authority. Solution of the problem is further complicated by the fact that any device the use of which is desirable in proper cases for the elimination of burdensome preferential rights of preferred stockholders may be used in other cases, without regard to corporate needs and for the sole benefit of common stockholders."

The defendants in this case admit that the plan was effected to benefit the common stockholders.

It is believed that this case is regarded already as a leading and chief authority in the field. The fundamental question today has become one of substantial importance to investors throughout the nation. Litigation on the question has arisen in various jurisdictions, but this Court has never passed upon the issue which by and large is fundamental in a large number of the past and current plans of reorganization and recapitalization. In view of its bearing upon investors generally, the question is one which should be passed upon by this Court so as to provide future guidance.

WHEREFORE, petitioner prays that a writ of certiorari may issue out of and under the seal of this Court, directed to the United States Circuit Court of Appeals for the Third Circuit, commanding the said Court to certify and send to this Court for review and determination as pro-

vided by law this cause and a complete transcript of the record and of all proceedings had herein; and that the order of the United States Circuit Court of Appeals affirming the judgment in this cause may be reversed and that petitioner may have such other and further relief in the premises as this Court may deem appropriate.

Dated, New York, September 25, 1941.

NORMAN JOHNSON,
Petitioner.

ARTHUR GARFIELD HAYS,
Solicitor for Petitioner.

VERIFICATION FOR THE PETITION.

UNITED STATES OF AMERICA,
SOUTHERN DISTRICT OF NEW YORK.

STATE OF NEW YORK,
COUNTY OF NEW YORK, } *ss.:*

NORMAN JOHNSON, being duly sworn, says:

I am the petitioner herein.

I have read the foregoing petition by me subscribed, and know the contents thereof. The facts therein stated are true to the best of my knowledge, information and belief.

NORMAN JOHNSON.

Sworn to before me this 25th day of September, 1941.

FREDERICK GRIFFIN,
Notary Public, New York County.
Commission expires March 30, 1942.

STATE OF NEW YORK,
COUNTY OF NEW YORK, } *ss.:*

I hereby certify that I have examined the foregoing petition for a writ of certiorari and that in my opinion it is well founded, and the cause is one in which the petition should be granted.

ARTHUR GARFIELD HAYS.

Sworn to before me this 25th day of September, 1941.

FREDERICK GRIFFIN,
Notary Public, New York County.
Commission expires March 30, 1942.

IN THE

SUPREME COURT OF THE UNITED STATES.

October Term, 1941.

Norman Johnson, Suing on Behalf of Himself and All Other Stockholders in The Curtis Publishing Company Similarly Situated Who, Being Interested in the Subject Matter of the Complaint, Shall Become Parties Hereto,

Petitioner,

against

Walter D. Fuller, Mary L. C. Bok, Fred A. Healy, Cary W. Bok, Benjamin Allen, Philip S. Collins, Bruce Gould, Philip S. Rose, Wesley W. Stout, Lewis W. Trayser, John B. Williams, and The Curtis Publishing Company,

Respondents.

BRIEF IN SUPPORT OF PETITION FOR CERTIORARI.

STATEMENT OF THE CASE.

The facts have been set forth in the foregoing petition.

QUESTIONS ARGUED.

The questions to be argued are those presented in the petition and restated as follows:

Point I.

The Circuit Court Erred in Failing to Enjoin Payments on the New Debentures and Prior Preferred Stock.

A.

The decision of the Circuit Court in refusing to enjoin payments on the new securities while accumulated dividends which accrued prior to the plan on the unexchanged preferred stock remained unpaid was apparently in conflict with the law of Pennsylvania as laid down by the Supreme Court of that Commonwealth.

In *West Chester and Philadelphia R. R. Co. v. Jackson,* 77 Pa. St. Rep. 321, where the circumstances as to dividends were analogous to the present case, the Court required the corporation to pay accumulated dividends in full when the initial dividend was declared on a new prior preferred stock. It seems impossible to distinguish that case from the one at bar on the facts. The railroad company had preferred and common stock outstanding, with dividend arrears on the preferred. The company having met with difficulties, obtained authorization by amendment of its charter to create a new issue of prior preferred stock to be given in exchange for the old preferred and accumulated dividends thereon. Stockholders were not obliged under the plan, however, to make the exchange. Plaintiff's intestate continued to hold the original preferred. Finally, the company declared its initial dividend consisting of 4% upon each class of preferred stock. Plaintiff's intestate demanded that all of the accumulations on his shares be paid on the dividend date. The company failed to comply with this demand. The plaintiff then brought an action of assumpsit for an amount equivalent to the accumulated unpaid dividends. Judgment in plaintiff's favor was

affirmed. The Court said that the stockholder's rights were governed by his contract with the corporation and that "his contract rights were precisely defined by the Act of 1855" (327). It was provided in that Act that holders of the preferred stock should be entitled to receive a stipulated rate of dividend "before any interest or dividend shall be paid to the holders of unpreferred stock" (322). Thus, the preference was of the same nature as petitioner's.

Since the Circuit Court based its refusal to grant relief on the theory that petitioner's preference was one only of priority over common stock, petitioner submits that the Circuit Court failed to follow the Pennsylvania law and erred in refusing to enjoin dividend payments on the company's new securities where accumulations remain unpaid on petitioner's shares.

B.

In its opinion, the Circuit Court said:

> "It is also true that the dividends upon the prior preferred stock are given priority of payment over dividends upon the preferred stock which accrued *after* the consummation of the reclassification * * * The appellees contend that the appellant has no vested right in priority under his contract with the company except as to those unpaid dividends which accrued *prior to the completion of the plan* and that he must look for the payment of these dividends to funds lawfully created for that purpose. Under the decisions we do not doubt that his right to the accumulated and unpaid dividends is a vested right." (Opinion, pp. 8, 9.) (Italics ours.)

The law does not deal in empty phrases and petitioner submits that in the light of the above remarks of the Circuit Court, the Court erred in failing to require the payment of dividends accrued prior to the plan before per-

mitting payments to be made on the new securities. The Circuit Court states that petitioner must look for the payment of the accumulated dividends "to funds lawfully created for that purpose." Yet the Court not only approved a plan whereby the equity in all of the defendant Company's funds, including its entire surplus, was diverted forever from the preferred stockholders but it also approved the distribution, through debentures of a large part of those funds to the new securityholders without requiring any amount to be paid to the preferred stockholders who refused to take the new securities.

POINT II.

The Circuit Court of Appeals Erred in Holding That the Plan of Reorganization and Recapitalization Did Not Unlawfully Impair Petitioner's Rights; and in Failing to Hold That the Pennsylvania Business Corporation Law Is Unconstitutional if Interpreted to Permit Said Plan.

A.

1. Petitioner submits that the Circuit Court erred because the 'Plan of Reorganization and Recapitalization" of The Curtis Publishing Company (hereinafter called the "Company") was unlawful as to him because, without his consent, it invaded the rights below mentioned which he was entitled to hold intact.

Stated in the simplest terms, petitioner contends that when a person purchases preferred stock of a corporation, certain rights spring into being, one of which is that the capital and surplus of the corporation (unless diminished by business losses or by distribution pro rata in dividends or on liquidation) will continue to remain behind his stock to safeguard his rights as to dividends and on liquidation; and that any "plan" which, without his consent, causes

such assets to be removed from behind his shares, is unlawful and invalid as to him. Certainly no investor would be disposed to purchase an interest in a company's stock if he knew that the assets composing the security behind his shares were to be eliminated, leaving his equity valueless.

In the present case, there were net assets equivalent to $52.80 behind each share of petitioner's stock before the plan. Immediately after the plan, and by reason of its effect, there were no assets behind petitioner's stock. In fact, the net assets of the Company were insufficient by a wide margin to take care of the new debenture issue and the liquidating rights of the prior preferred stock. The claim of the debentures and the preferential claim on liquidation of the prior preferred stock was approximately $49,750,000, whereas, the Company's net assets were $38,000,000. Against each share of prior preferred stock having a preferential claim on liquidation of $65, plus accrued dividends, there were net assets of approximately $48 per share. Thus, all of the security behind the original preferred stock was drained away by the plan.

It is true that petitioner had the option of exchanging his stock for the new securities against which the Company's assets were being placed. The "option", however, could be exercised only if petitioner waived substantial rights, such as his right to accumulated dividends.

2. Although not questioning that the petitioner holds a vested right to unpaid dividends which accrued prior to the completion of the plan, the Circuit Court held (erroneously as petitioner contends) that the petitioner's rights as a preferred stockholder are limited strictly to a preference over common stockholders.

The point now under discussion can best be illustrated as follows: The defendants have asserted in the Courts be-

low, and the Circuit Court has held, that the unalterable rights of preferred stockholders in this case consist of:

> (1) The right to receive currently accruing dividends, or, in the event of liquidation, the right to receive $100 per share plus accrued dividends before corresponding payments may be made to common stockholders;
>
> (2) The right to receive payment of accumulated unpaid dividends before dividends may be paid to common stockholders.

The Circuit Court has held that since the above rights have not been disturbed in a literal sense, the reorganization is valid since it was adopted under Article VIII of the Business Corporation Law of 1933 of Pennsylvania (15 P. S. Pa. Section 2852-801 (4)), which permits reclassification of shares (Opinion, pp. 13, 14). Petitioner claims, however, that his inalienable rights are more extensive and include not only the two abovementioned but also the following:

> (3) The right to have the corporate assets employed exclusively for corporate purposes—and particularly in this case, the right to restrain direct or indirect employment of the corporate assets for the benefit of controlling stockholders to the detriment of minority, non-consenting stockholders;
>
> (4) The right to parity with all other preferred stockholders of the same class so far as treatment by the corporation is concerned.

As shown above, the Company assets in their entirety in this case have been shifted away from dissenting stockholders, not for the accomplishment of any corporate purpose, but only for the admitted purpose of bettering the position of the common stockholders.

Likewise, petitioner has not been treated on a parity with other preferred stockholders. It is fundamental that a dividend may not be paid to some preferred stockholders while others of the same class remain unpaid. *Cratty v. Peoria Law Library Ass'n,* 219 Ill. 516, 76 N. E. 707; *Godley v. Crandall & Godley Co.,* 212 N. Y. 121, 105 N. E. 818. The distribution of debentures in this case amounted to a dividend. It is true that under the plan the petitioner could have received his proportionate share of debentures but only if he gave up his vested right to accumulated dividends amounting to substantially more than the debentures being offered to him. It cannot be truly said that the right to receive a dividend on the basis of equality with others of the same class exists where the dividend will not be paid unless the stockholder waives valuable vested rights.

3. It appears to have been conceded by the Circuit Court that vested rights are inalienable and not subject to divestment under the Business Corporation Law of Pennsylvania. The Circuit Court erred in not recognizing that the rights mentioned in the second box, supra, are inalienable vested rights as well.

This Court and other Courts have discussed "vested rights," but apparently have nowhere defined that term. For illustration:

In *Stokes v. Continental Trust Company,* 186 N. Y. 285, the Court held that the right of preferred stockholders to a proportionate share of the corporate surplus is an inherent and vested right of property.

In *Keller v. Wilson,* Del. 190 Atl. 115, it was held that the right of a preferred stockholder to accumulated dividends is a vested right of property secured against destruction by the Federal Constitution.

In *Coombes v. Getz,* 285 U. S. 434, the accrued right of a corporation's creditor to hold a director personally liable to him, up to the amount of his debt, for funds embezzled from the corporation was held "vested" and inalienable although the statute under which the right was asserted was repealed before the creditor obtained judgment. In that case, the Court said at 441, 442:

> "The authority of a state under the so-called reserved power is wide; but it is not unlimited. The corporate charter may be repealed or amended, and, within limits not now necessary to define, the interrelations of state, corporation and stockholders may be changed; but neither vested property rights nor the obligation of contracts of third persons may be destroyed or impaired."

In *Matter of Kinney,* 279 N. Y. 423, 18 N. E. (2d) 645 (a case of recapitalization involving a "voluntary" exchange of preferred for prior preferred stock, the waiver of accumulated dividends and a reduction of capital just as in the present case), the Court upheld dissenting stockholders' rights to appraisal of their shares. The Court said:

> "When this sum * * *, amounting to about one-third of the capital of the corporation, was transferred from capital to surplus, the eight-dollar cumulative preferred stock lost its right to rely upon this portion of capital * * *. The reduction in capital constitutes a material alteration of the preferential rights of the old preferred * * *" (279 N. Y. at 431).

In *Chicago, M. St. P. R. R. Co. v. Wisconsin*, 238 U. S. 491, the Court stated, at p. 501:

> "In the brief of counsel for the State it is argued that the statute can be sustained as a valid exercise of the State's reserved power to alter the charter of the Company. That question does not seem to have been raised in the state court, nor was its decision based on that proposition. Indeed such a ruling would seem to have been opposed to State ex rel. Northern Pacific v. R. R. Commission, 140 Wisconsin, 157, and the Water Power Cases, 148 Wisconsin, 124, where it was held that the right to amend a charter does not authorize the taking of the Company's property without just compensation. The same view has been repeatedly expressed in the decisions of this court. For example, in Shields v. Ohio, 95 U. S. 324, it was said that 'the power of alteration and amendment is not without limit. *The alterations must be reasonable* * * * *and consistent with the scope and object of the act of incorporation.'* * * * Again in Stearns v. Minnesota, 179 U. S. 223, 259, it was held that *the reserved right to amend a corporate charter 'does not confer mere arbitrary power, and cannot be so exercised as to violate fundamental principles of justice by* * * * *taking of property without due process of law.'* Lake Shore &c. Ry. v. Smith, 173 U. S. 690; Stanislaus Co. v. San Joaquin Co., 192 U. S. 201; Sinking-Fund Cases, 99 U. S. 720; Miller v. State, 15 Wall. 498; * * *" (Italics ours.)

It is petitioner's contention that the plan which deprived him without his consent of all the assets and security behind his shares, invaded his vested rights to enjoy the benefits of such assets and security on a parity with all preferred stockholders, and that the Circuit Court erred in failing so to hold and to invalidate the plan as to him, or otherwise to hold unconstitutional the statute which countenanced it.

POINT III.

The Circuit Court Erred in Failing to Follow the Principle of Southern Pacific Co. v. Bogert, 250 U. S. 483, and Jones v. Missouri-Edison Electric Co., 144 Fed. 765, Certiorari Denied 229 U. S. 615.

The record discloses with unusual frankness that the dominant-common-stock-management called for a sacrifice by the preferred stockholders and promulgated the plan for their own benefit. The Company's treasurer testified that although the Company's surplus was very large it was the opinion of the management that the preferred stockholders "would be milking the company" if the surplus funds were used to pay accumulated preferred stock dividends (83). Witnesses produced by the defendants testified that it was the purpose of the plan to improve the position of the company's common stockholding management who otherwise might try "to make money in other ways" which would be "entirely unfortunate from the point of view of a preferred stockholder" (86, 93, 95, 96). The company's credit position was so "superlatively good" (87) that there was no "financial stringency" (91) which required any plan of reorganization.

In these circumstances, it is plain that the plan did not serve any valid corporate purpose. It is true that the equity in the Company's assets was shifted to the holders of the new debentures and prior preferred stock and not to the common stockholders. It is true also that petitioner's priority of claim still ranks ahead of the common stockholders. The result and the stated intendment of the plan, nevertheless, was to eliminate as much as possible of the accumulated dividends so that the common stockholders might receive dividends sooner than if the accumulated

dividends were to be recognized and paid in full. In order to accomplish this, the preferred stockholders had either to give up substantial rights if they accepted the plan, or see their equity entirely vanish and their prospect of receiving dividends grow so remote as virtually to be meaningless. It is this of which petitioner complains.

The facts, in addition, throw doubt upon the bona fides of the management who in submitting the plan to stockholders claimed that it was advisable to eliminate rather than pay the accumulated dividends. The fact is that the same management, instead of paying the dividends, used $5,938,137 of the Company's surplus to purchase the Company's own shares in the market, and an additional $6,700,000 in the issuance of debentures under the plan. Had these amounts been applied to the payment of dividends to the class as a whole, the accumulations would have been practically paid up in full.

Petitioner asserts, therefore, that the Circuit Court erred in refusing to find the plan invalid by reason of the action of the dominant common stockholders in benefiting themselves to the disadvantage of the preferred stockholders.

POINT IV.

The Circuit Court Erred in Failing to Invalidate the Plan Because of Its Failure to Recognize and Apply the Rule of Priority.

In *Petry v. Harwood Electric Co.*, 280 Pa. St. Rep. 142, 124 Atl. 302, where a merger had occurred, appraisers appointed under the statute found a value equal to par and accumulated dividends for preferred shares held by a dissenting stockholder. Under the merger plan common stock-

holders received common stock of the surviving corporation. The Supreme Court of Pennsylvania upheld the valuation, stating as one of its main grounds:

> "If there were not sufficient assets to pay the preferred stockholders par and accrued dividends, then, as against the common stockholders, the preferred ones were entitled in the merger to get all of the stock distributable to the defendant company, and the common stockholders would not be entitled to receive any of it. As a matter of fact, the common stockholders received for their stock in the defendant company large holdings of stock in the merged company. They could not justly and equitably deny to the preferred stockholders that which was due to them, and at the same time hold on to the stock of the new company which they had received because of their ownership of common stock in the defendant." (280 Pa. at 156.)

Thus, in a merger as distinguished from an equity reorganization, the Court recognized and gave expression to the priority rule of *Northern Pacific Co. v. Boyd* and subsequent equity decisions.

In the present case, although for many years and at the time of the plan there was a large surplus freely used as such by the company, there was no equity whatever for the common stockholders. This was admitted by the defendants (85) and was stated by the Company's accountants in the balance sheet submitted with the plan (41).* The explanation for this apparent paradox lies in the fact that the company carried its stated capital at a figure far

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* The audited balance sheet states:

"The excess of the Preferred Stock Liability amounts to $47,179,053.49
Common Stock, No Par Value Shares in hands of Public, 1,730,101
Liquidating Liability Nothing"

below the liquidating preference of the preferred stock. Not only was there no equity for the common stock but the Company's treasurer emphatically stated that it would never be possible for the Company to acquire sufficient net assets to redeem the preferred stock (72) or pay it off in full on liquidation (85). In spite of this situation the common stockholders received new common stock, share for share, in the reorganization.

In view of the decision in *Petry v. Harwood Electric Co.*, supra, it seems probable that the priority rule in essence would be deemed applicable by the appellate courts in Pennsylvania. Moreover, the current evolution of corporate law as exemplified by the decisions of this Court in *Case v. Los Angeles Lumber Products Co. Ltd.*, 308 U. S. 106, and *Consolidated Rock Products Co. v. DuBois*, 312 U. S. 510, as well as the interesting decision of the Securities & Exchange Commission in the recapitalization case of Federal Water Service Corporation et al., Holding Company Act Release No. 2635, March 24, 1941, point in the direction of judicial and administrative insistence that junior securityholders be dealt with according to rank where the rights of classes are shuffled.

In the present case, we have the extraordinary situation of the Company's so-called top heavy capitalization being cured by cutting it off at the top. This runs violently counter to all principles of fairness. Petitioner submits, therefore, that even were the law to permit recapitalization in proper cases along the general lines of the plan in the present case, the Circuit Court erred in refusing to find that the plan in this case is unfair and unlawful. If the decision in this case remains undisturbed, the institution of preferred stock hitherto considered as a medium of in-

vestment may well be eliminated, for the safeguards with which investors thought themselves surrounded are, as it seems, largely illusory.

It is not to be overlooked that the situation presented by this case is relatively new insofar as it exemplifies action which is being undertaken by many corporations today. It is only through this Court that an authoritative rule can be laid down for the guidance of investors and corporations alike.

CONCLUSION.

It is respectfully submitted that the questions involved in this application are of great importance to investors throughout the United States and that such questions require the exercise of this Court's supervisory jurisdiction by writ of certiorari.

Respectfully submitted,

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Appendix.

STATUTES INVOLVED.

Title 15, Pennsylvania Statutes.
Article VIII—Amendment of Articles.
§ 2852-801 Amendment of Articles Authorized.

A business corporation, in the manner hereinafter provided in this article, may from time to time amend its articles:

(1) To adopt a new name, subject to the restrictions heretofore provided in this act;

(2) To modify any provision thereof limiting its term of existence by increasing such term, or to remove such provision and provide for perpetual existence;

(3) To change, add to, or diminish its powers or purposes, or to set forth different or additional powers or purposes;

(4) To increase or diminish its authorized capital stock, or to reclassify the same by changing the number, par value, designations, preferences, or relative, participating, optional or other special rights of the shares, or the qualifications, limitations, or restrictions of such rights, or by changing shares with par value into shares without par value, or shares without par value into shares with par value, either with or without increasing or decreasing the number of shares; and in any and as many other respects as desired, provided that the articles, as so amended, would be authorized by this act as original articles of incorporation. (1933, May 5, P. L. 364, art. VIII, § 801.)

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IN THE

Supreme Court of the United States

October Term, 1941.

No. 656.

NORMAN JOHNSON, Suing on Behalf of Himself and All Other Stockholders in THE CURTIS PUBLISHING COMPANY, Similarly Situated Who, Being Interested in the Subject Matter of the Complaint, Shall Become Parties Hereto,

Petitioner,

against

WALTER D. FULLER, MARY L. C. BOK, FRED A. HEALY, CARY W. BOK, BENJAMIN ALLEN, PHILIP S. COLLINS, BRUCE GOULD, PHILIP S. ROSE, WESLEY W. STOUT, LEWIS W. TRAYSER, JOHN B. WILLIAMS, and THE CURTIS PUBLISHING COMPANY,

Respondents.

Brief for Respondents in Opposition to the Petition for Writ of Certiorari.

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IN THE

Supreme Court of the United States.

No. 656. October Term, 1941.

NORMAN JOHNSON, SUING ON BEHALF OF HIMSELF AND ALL OTHER STOCKHOLDERS IN THE CURTIS PUBLISHING COMPANY, SIMILARLY SITUATED WHO, BEING INTERESTED IN THE SUBJECT MATTER OF THE COMPLAINT, SHALL BECOME PARTIES HERETO,

Petitioner,

against

WALTER D. FULLER, MARY L. C. BOK, FRED A. HEALY, CARY W. BOK, BENJAMIN ALLEN, PHILIP S. COLLINS, BRUCE GOULD, PHILIP S. ROSE, WESLEY W. STOUT, LEWIS W. TRAYSER, JOHN B. WILLIAMS, AND THE CURTIS PUBLISHING COMPANY,

Respondents.

BRIEF FOR RESPONDENTS IN OPPOSITION TO THE PETITION FOR WRIT OF CERTIORARI.

Opinions of the Courts Below.

The opinion of the District Court is reported in 36 Fed. Supp. 744. The opinion of the Circuit Court of Appeals is reported in 121 F. (2d) 618.

Statement of the Case.

This is an action in equity whereby petitioner, a holder of Respondent Company's Preferred Stock sought, in the alternative, a decree enjoining the payment of dividends

on the Respondent Company's Prior Preferred Stock and interest on its Debentures, so long as any shares of the Company's Preferred Stock remain outstanding, and declaring the issue of the Prior Preferred Stock and Debentures null and void; or a decree requiring the individual Respondents to account to the Respondent Company for the full consideration which, it is alleged, the Respondent Company should have received with respect to the issuance of the Prior Preferred Stock and Debentures (R. *12, 13*).*

The Prior Preferred Stock and Debentures were issued pursuant to a Plan of Reorganization and Recapitalization (hereafter called the Plan) adopted by the stockholders (R. *31*, 1). The Bill of Complaint challenged the validity of the Plan on legal and equitable grounds (R. *11, 12*). Respondents contended that the Plan was valid and equitable, and made the further defense that Petitioner was barred by laches.

The jurisdiction of the District Court was based on diversity of citizenship (R. *3, 19*).

After hearing on the merits, the District Court found the Plan valid and equitable, dismissed the complaint, and entered judgment for the Respondents. The Court held it unnecessary to consider the question of laches (R. *1, 135*).

On appeal, the Circuit Court of Appeals affirmed the judgment of the District Court, likewise without passing on the question of laches (R. 53, 54).

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*References are to pages of that part of the record to be considered on the Petition for Certiorari. References to pages in Appellant's Appendix are printed in italics; those to pages in Appellees' Appendix and other parts of the record in plain type.

Respondents wish to point out an omission of a material fact in Petitioner's "Summary Statement of the Matter Involved". (It should be noted here that Petitioner's ignoring of this important fact infects the Petition and the entire reasoning of Petitioner with a false major premise.) Petitioner avers (Petition, p. 2) that the Plan purported to be effected under Section 801 of the Business Corporation Law of the Commonwealth of Pennsylvania, Act of May 5, 1933, P. L. 364. However, he fails to set forth or mention anywhere in his Petition or Brief the Resolution adopted December 16, 1925 by the stockholders of Respondent Company pursuant to which the Preferred Stock was issued and setting forth its preferences and limitations (R. *20, 26*). These terms were printed in full on the reverse side of each certificate of Preferred Stock, and include the following provision, which supplies the authority for the action taken (R. *20, 27*):

> "So long as any of the Preferred Stock remains outstanding, *the Company will not, without the consent of the holders of two-thirds of the Preferred Stock outstanding, create any mortgage debt or other obligation which would be entitled to payment out of the assets of the corporation prior to the Preferred Stock,* excepting only such obligations as may be incurred in the ordinary and usual course of business, not secured by a lien upon the Company's property, and excepting also purchase money obligations given in connection with the acquisition of new property, *nor shall the Company, without such consent, create any other issue of stock which shall in any way impair the rights of the holders of the present issue of Preferred Stock.*" (Italics supplied.)

Petitioner also makes a misstatement of fact, namely, that under the Plan the Common stockholders received new

Common Stock, share for share (Petition and Brief, pp. 3, 8, 29). Under the Plan, the Common stockholders retained their original shares and suffered a diminution of almost 50% in their common stock equity through the issuance of additional Common Stock to Preferred stockholders who chose to make the exchange (R. *23, 31, 123*).

Respondents represent that the respective findings of the Courts below, as set forth in the Opinions, correctly present the Plan, its authorization and its effect on Preferred and Common stockholders, and also preclude and answer Petitioner's argumentative and one-sided statement of evidence relative to the fairness of the Plan and the good faith of the directors and officers.

Question Presented.

Where preferred stockholders contract that obligations and new issues of stock which impair their rights may be created by 2/3 consent, is a plan of recapitalization, involving the authorization and issue of debentures, prior preferred stock (having priority over the existing preferred stock with unpaid accrued cumulative dividends) and common stock in exchange for existing preferred stock to those wishing to make the exchange, valid where such 2/3 consent is obtained?

SUMMARY OF ARGUMENT.

Respondents contend that (1) no federal question is involved, (2) the question presented is one of purely local law decided in a way not in conflict with local decisions, and (3) the decision of the Circuit Court of Appeals has the support of the judgment of every court which has ever decided the question presented on final hearing.

ARGUMENT.

I. The Case at Bar Presents No Federal Question.

No federal question can be raised under the facts of this case. Petitioner several times asserts by means of rhetorical questions in his Petition for Certiorari that if the Pennsylvania Business Corporation Law authorized the adoption of the Plan that law violates Article I, Section 10 and the Fourteenth Amendment of the Constitution of the United States. A cursory examination of the facts of the case will show that these assertions are hypothetical in fact as well as form.

The Resolution of December 16, 1925 (supra, p. 3), which Petitioner ignores, constitutes the contract between Petitioner, the other stockholders, and Respondent Company. The Plan was adopted pursuant to the express provisions of that Resolution authorizing the creation of obligations and issuance of stock having priority over the Preferred Stock upon consent of two-thirds thereof. The Pennsylvania Business Corporation Law served only to implement the authority granted in the contract by providing the procedure followed in adoption of the Plan. Respondents respectfully submit that action taken pursuant to an express provision of a contract cannot constitute an impairment of that contract or a taking of property without due process of law within the meaning of Article 1, Section 10, or Section 1 of Amendment XIV of the Constitution of the United States.

Respondents' conclusion that the Plan violated no Federal Constitutional right of Petitioner finds authoritative support in a recent decision of this Court, notwithstanding Petitioner's claim (Petition & Brief, pp. 11, 13, 14, 30)

that this Court has never passed upon that issue. The same general Constitutional issues as are here urged were involved in *Kreicker v. Naylor Pipe Co.*, 374 Ill. 364, 29 N. E. (2d) 502 (1940) which upheld a substantially similar plan of recapitalization. An appeal was taken to this Court from that decision. This Court, per curiam (312 U. S. 659), granted a motion to affirm the judgment of the state court on the ground that no Federal Constitutional right was violated.

II. The Decision of the Circuit Court of Appeals Does Not Conflict With Applicable Local Decisions.

Respondents believe that the only question in this case (other than the question of laches which was not decided) is the interpretation of a Pennsylvania contract. No Pennsylvania decisions dealing with a similar contract have been found.

Analysis of *West Chester and Philadelphia R. R. Co. v. Jackson*, 77 Pa. 321 (1875) (cited by Petitioner for the first time in this Court) demonstrates that it is not in point.

Defendant in that case was incorporated by a Special Act of Assembly of 1848. Pursuant to a supplemental Act of Assembly of 1855, defendant issued preferred stock entitled to dividends of 8% per annum before any dividends should be declared or paid in favor of or to any holder of the "unpreferred" stock of the company. At the time of the issuance of this preferred stock only common stock was authorized or outstanding. The Act of 1855 did not reserve in the legislature or in less than 100% of the stockholders the power to issue any other stock which would impair the rights of the holders of the preferred stock. By supplemental Acts of Assembly of 1870 (1871 Pamph-

let Laws) and 1872 the legislature authorized the defendant, with the approval of the holders of a majority of the stock, to issue consolidated preferred stock for retirement and cancellation of *all* stock previously issued, both preferred and common. The consolidated preferred stock was entitled to cumulative dividends of 8% per annum before the holder of any stock thereafter issued or otherwise authorized should receive any dividend. The relationship between this new stock and the old preferred stock was not defined.

Pursuant to this authorization the defendant offered and issued shares of consolidated preferred stock to holders of the preferred stock on the basis of three shares for two and to holders of the common stock on a share for share basis. Thereafter, defendant declared and paid a 4 per cent. dividend on the unexchanged preferred and the consolidated preferred stock. Plaintiff, who had declined to exchange his preferred stock, then claimed that he was entitled to the unpaid cumulative dividends accrued on his preferred stock and sued in assumpsit.

The court held that as against the unexchanged preferred stock (42 shares), the new consolidated preferred stock was common stock, by whatever name called, and that plaintiff was therefore entitled to his full accrued dividends. This conclusion followed from the fact that by paying a dividend on the consolidated preferred which had been issued to the common stockholders the defendant had in fact and in effect paid a dividend to the latter in contravention of preferential rights of the holders of the old preferred stock. In the case at bar, the Plan preserves the contractual preferences of Preferred Stock over Common Stock. The West Chester case is also distinguishable in that there was no reservation of a power to issue addi-

tional stock affecting the rights of holders of the preferred stock.

The only other Pennsylvania case cited by Petitioner is *Petry v. Harwood Electric Co.* (*No. 1*), 280 Pa. 142, 124 Atl. 302 (1924), which is not relevant and is discussed below (p. 10).

III. The Decision of the Circuit Court of Appeals Is Supported by the Judgment of Every Other Court Which Has Decided the Question Involved on Final Hearing.

Respondents take issue with Petitioner's statement (Petition, p. 13) to the effect that the law on the question presented is in a state of confusion, "with conflicting decisions on every side and the rights of investors left to the unguided judgment of each particular judge". Respondents believe that the decision of the Court below has the support of the judgment of every court which has decided this question on final hearing. These decisions follow:

Kreicker v. Naylor Pipe Co., 374 Ill. 364, 29 N. E. (2d) 502 (1940), aff'd 312 U. S. 659 (1941);

Ainsworth v. Southwestern Drug Corporation, 95 Fed. (2d) 172 (C. C. A. 5th, 1938);

Johnson v. Lamprecht, 133 Ohio St. 567, 15 N. E. (2d) 127 (1938);

Shanik v. White Sewing Machine Corp., 19 Atl. (2d) 831 (Del. Sup. Ct., 1941);

Blumenthal v. DiGiorgio Fruit Corp., 30 Cal. App. (2d) 11, 85 Pac. (2d) 580 (1938).

Throughout the proceedings in the case at bar, Petitioner has argued for the application to this case of the results reached in a line of cases, headed by *Keller v. Wilson & Co.*, 190 Atl. 115 (Del. Sup. Ct. 1936), which assert

that preferred stockholders have a "vested right" to accrued cumulative dividends. However, the right protected by these cases may properly be defined as the right of preferred stockholders to have accrued cumulative dividends paid before any dividends are paid on the common stock. The only limitation on corporate action to be found in these cases is a prohibition of charter amendments operating directly on a class of preferred stock so as to wipe out its preferences over common stock with respect to accrued cumulative dividends. Thus, the same courts which have recognized a "vested right" to accrued cumulative dividends have invariably held that plans such as that in the case at bar were valid and did not violate that right, since the preferences of the preferred stock over the common stock were preserved. See *Shanik v. White Sewing Machine Corporation*, 19 Atl. (2d) at pp. 834, 835.

Petitioner argues that the decision in this case conflicts with the principle of *Southern Pacific Co. v. Bogert*, 250 U. S. 483 (1919), and *Jones v. Missouri-Edison Electric Co.*, 144 Fed. 765 (C. C. A. 8th, 1906). (For further proceedings in the Jones case see 199 Fed. 64 and 203 Fed. 945. The denial of certiorari, 229 U. S. 615, cited by Petitioner, applies to the decision in these further proceedings.) These cases establish the principle of corporate law and equity that majority stockholders may not through their voting control impose upon the minority stockholders a transaction or plan which discriminates in the issue of new securities in favor of the majority against the minority. This principle is well settled in the law, but has no application to the case at bar where the Plan, adopted by more than two-thirds of the Preferred Stock voting as a class,

offered exactly the same exchange privileges to all Preferred stockholders.

Lastly, Petitioner argues that the decision in this case conflicts with the principle, enunciated in such cases as *Northern Pacific Ry. Co. v. Boyd*, 228 U. S. 482 (1913), and *Case v. Los Angeles Lumber Products Co. Ltd.*, 308 U. S. 106 (1939), and applied in equity receiverships and bankruptcy reorganizations, which requires the payment in full of senior interests as if on liquidation before junior interests not contributing fresh assets are entitled to recognition. Petitioner also cites *Petry v. Harwood Electric Co. (No. 1)*, 280 Pa. 142, 124 Atl. 302 (1924), involving the rights of dissenting preferred stockholders in a merger which, according to the Pennsylvania Supreme Court, operated as a dissolution insofar as such stockholders were concerned.

The Plan involved no liquidation of the Respondent Company in any sense. It was not, like an equity receivership or bankruptcy reorganization, a substitute for forced liquidation. It did not, like a merger, effect the dissolution of the Respondent Company and thus bring into play the liquidation rights enforced in the Petry case.

In the last analysis, this is a case where stockholders, acting under their contract of association as interpreted by local law, have agreed to a readjustment of their respective rights by a plan of recapitalization which the Circuit Court of Appeals has found fair and validly authorized by their mutual contract and by local law.

Conclusion.

For the above reasons, it is respectfully submitted that the application of the Petitioner for Writ of Certiorari to review the judgment of the Circuit Court of Appeals should be denied.

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Respondents.

PETITIONER'S REPLY BRIEF.

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IN THE

Supreme Court of the United States.

No. 656. October Term, 1941.

NORMAN JOHNSON, SUING ON BEHALF OF HIMSELF AND ALL OTHER STOCKHOLDERS IN THE CURTIS PUBLISHING COMPANY, SIMILARLY SITUATED WHO, BEING INTERESTED IN THE SUBJECT MATTER OF THE COMPLAINT, SHALL BECOME PARTIES HERETO,

Petitioner,

—against—

WALTER D. FULLER, MARY L. C. BOK, FRED A. HEALY, CARY W. BOK, BENJAMIN ALLEN, PHILIP S. COLLINS, BRUCE GOULD, PHILIP S. ROSE, WESLEY W. STOUT, LEWIS W. TRAYSER, JOHN B. WILLIAMS, AND THE CURTIS PUBLISHING COMPANY,

Respondents.

PETITIONER'S REPLY BRIEF.

I.

The respondents' argument in chief is that the contract of the preferred stockholders as described in the corporate resolution dated December 16, 1925 (Respondents' Br., 3) permits an amendment to the preferred stock contract and the creation and issuance of new securities as in this case, *conditioned only upon the consent of the holders of two-thirds of the preferred stock outstanding.* If re-

spondents' thesis were correct, then any change whatsoever in the relation of a stockholder to the corporation and to the other stockholders could be effected merely upon a sufficient vote percentagewise. The argument is untenable for it fails to take into account:

(a) The restrictions upon the exercise of the reserved power which have been recognized by the law for many years.

(See cases cited in Petitioner's Main Brief, Point II.)

(b) The well-established lines of cases holding that regardless of the vote the amendment must be fair and equitable (Points III and IV of Petitioner's Main Brief).

Respondents misapprehend petitioner's argument as to the duty owed to the minority by stockholders in control of a corporation. Respondents argue that the majority did not impose upon the minority in this case because all of the preferred stockholders were offered the same exchange privileges. The point urged by petitioner, however, is that the dominant common stockholders who were in complete control of the corporation and the directors whom they elected sponsored the plan with the intent and for the purpose of benefiting themselves at the expense of preferred stockholders; respondents' own witnesses so admitted (Petition 6, Main Brief 26).

In *Southern Pacific Co. v. Bogert*, 250 U. S. 483, the majority stockholders overreached at the expense of the minority and the Court granted relief to the minority. The Court said at page 487:

> "The rule of corporation law and of equity invoked is well settled and has been often applied. The The majority has the right to control; but when it does

so, it occupies a fiduciary relation toward the minority, as much as the corporation itself or its officers and directors."

More recently, in *Pepper v. Litton,* 308 U. S. 295, the Court said at page 306:

> "* * * A director is a fiduciary. *Twin Lick Oil Co. v. Marbury,* 91 U. S. 587, 588. So is a dominant or controlling stockholder or group of stockholders. *Southern Pacific Co. v. Bogert,* 250 U. S. 483, 492. Their powers are powers in trust. See *Jackson v. Ludeling,* 21 Wall. 616, 624. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. *Geddes v. Anaconda Copper Mining Co.,* 254 U. S. 590, 599. *The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside."* (Italics ours.)

(c) The contract provision of the preferred stock quoted in respondents' brief (p. 8) refers only to a charter amendment as to the creation of securities, not their issuance. Petitioner's contention that the new securities, including the debentures, were issued without valid consideration *benefiting the corporation* remains unanswered.

II.

Respondents are correct in stating that the common stockholders did not receive new common but merely retained their original shares but are in error when they state that these shareholders gave up "almost 50% in their com-

mon stock equity." Whatever equity had originally been applicable to the common stock had long since been wiped out. Therefore there was no equity for them to give up (Appellant's Appendix 85, 41).

III.

In attempting to distinguish the case of *Westchester and Philadelphia R. R. Co. v. Jackson*, 77 Pa. 321, respondents fall back on the curious assertion that the Court held the new consolidated preferred stock to be common stock, by whatever name called. Further study of that case fails to disclose any assertion or reasoning by the Court justifying such an analysis. On the contrary, the new stock had attributes which common stock does not have: it had a fixed dividend rate (8%); the dividend was cumulative; it held a preference over any other stock as to dividends.

The claim that in the *Westchester* case there was no reservation of a power to issue additional stock is likewise fallacious. The reserve power is inherent in the legislature limited only by the extent to which rights are "vested." To say that the reserve power to issue stock was not evidenced by the corporate charter in the *Westchester* case is merely begging the question.

The statute (contract) in the *Westchester* case authorized the issuance of the new preferred upon the affirmative vote of a majority of the stock. If the argument adopted by respondents in defense of their own reorganization were applied in the *Westchester* case, where an overwhelming majority vote was obtained, the dissenting preferred stockholder in that case would have had no redress. That case illustrates the absurd result to which respondents' thesis leads: since the exchange offer in that case was open to

common as well as preferred shareholders, the common became preferred over the dissenting original preferred

IV.

In asserting that this case presents no federal question, the respondents rely on *Kreicker v. Naylor Pipe Co.*, 374 Ill. 364, 29 N. E. (2d) 502, affd. 312 U. S. 659. It will be observed, however, that the *Kreicker* case was an appeal from a decision of the highest court of the State of Illinois construing a contract made by an Illinois corporation under the laws of that state. The cases cited by this Court in affirming that decision were all cases likewise involving appeals from the highest court of each state in the respective cases. The present case, however, does not come to this Court from a state court but from the United States Circuit Court of Appeals. The subject matter of this action lies directly in the jurisdiction of the United States Courts on the basis of diversity of citizenship between the parties; and the cases heretofore decided by the highest court of the Commonwealth of Pennsylvania and with which the decision of the Circuit Court appears to be in conflict are cited in the petition (8, 11).

V.

The cases upon which respondents rely in support of their general position (Resp. Brief 8) all differ from the present case upon the facts therein involved. The following are among the distinguishing features of these cases:

(a) In the present case the respondents' witnesses testified that no reorganization was necessary because of the company's financial condition, which was excellent, and that the plan was motivated instead by the common stockhold-

ers' financial position in relation to the company (Main Brief 26). In each of the cases cited by respondents, the corporation itself was expressly found by the Court to be in serious financial difficulties. In fact, in *Johnson v. Lamprecht,* 133 Ohio St. 567, 15 N. E. (2d) 127, the Court said:

> "If there is a surplus the action usually has been enjoined."

In the present case, the respondent corporation had a fund designated "Contingent Reserve (earned) and Undivided Profits" amounting to $20,251,304.61 available for payment of dividends (Petition 5; Appellant's Appendix 41).

(b) In the present case through the medium of debentures a large portion of "surplus" was made available to assenting preferred stockholders but withheld from non-assenting shareholders of the same class. This did not occur in any of the cases cited except in *Ainsworth v. South Western Drug Corp.,* 95 Fed. (2d) 172, where the accumulated dividends were paid to assentors *in full* by the issuance of income dividend notes.

(c) In the present case, the evidence showed that the corporation through purchases of its own stock and the issuance of debentures created charges to "surplus" substantially equal to the full amount of the accumulated dividends on all of the outstanding shares of preferred stock. This was not true in the cited cases except to an extent in the *Ainsworth* case as pointed out above.

(d) In the present case, petitioner contends that the right of parity among the preferred stockholders was violated. The question of parity was not considered by the Court in any of the cases cited by respondents.

Citation of these cases by respondents in no way alters the fact that conflicts and uncertainties in the law exist as shown in petitioner's petition. For example, if the cases on which respondents rely are to be construed as they construe them, then the case of *Buckley v. Cuban American Sugar Co.* (New Jersey Chancery Court, New Jersey Law Journal, August 22, 1940), is directly contrary. There the sugar company had 7% Preferred Stock ($100 per share) and Common Stock outstanding. Accumulated dividends on the Preferred Stock amounted to $54.50 per share. The company offered to exchange for each share of Preferred:

1 4/10 shares of 5½% Convertible Preferred Stock (par value $100 per share);

$14.50 in cash.

The company had an earned surplus of $16,000,000. The plan was enjoined.

In fact, the New Jersey cases as a whole appear contrary. (*General Investment Co. v. American H. & L. Co.*, 98 N. J. Eq. 326, 129 Atl. 244).

Conflict also exists between the present case and certain statements in *Yoakam v. Providence Biltmore Hotel Co.*, 34 Fed. (2d) 533. In the *Yoakam* case, the Court declared (542) that any reclassification which permits surplus existing at the time the plan is consummated to be used for payments to newly created senior securities would be invalid. In the present case as it stands, there is nothing to protect the $20,000,000 Contingent Reserve (earned) and Undivided Profits against invasion by the stockholders assenting to the plan. Not only may they receive dividends from this fund, but if the corporation were liquidated today, the assentors would receive the entire fund to the exclusion of the non-assentors.

The unsatisfactory and unsettled state of the law is indicated by the recent articles and notes appearing in the law reviews. For example, see *Accrued Dividends on Cumulative Preferred Stocks: The Legal Doctrine* by John F. Meck, Jr., Harvard Law Review, Vol. LV, No. 1, p. 71, November, 1941.

The within case affords the opportunity of settling this important problem authoritatively.

Respectfully submitted,

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Solicitor for Petitioner.